

**COMMONWEALTH OF MASSACHUSETTS  
DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY**

**BOSTON GAS COMPANY d/b/a  
KEYSPAN ENERGY DELIVERY  
NEW ENGLAND**

**D.T.E . 03-40**

**INITIAL BRIEF OF  
BAY STATE GAS COMPANY**

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## **I. INTRODUCTION**

On April 16, 2003, Boston Gas Company d/b/a Key Span Energy Delivery New England (“Boston Gas” or “the Company”) filed with the Department of Telecommunications and Energy (“Department”) under G.L. c. 164, sec. 94 for rate relief. As part of that filing, consistent with the Department’s requirements, Boston Gas filed a performance-based rate plan (“PBR”). See, Department Investigation into Incentive Regulation, D.P.U. 94-158 at 65-66 (1995) (“Incentive Regulation”). Boston Gas filed testimony to support its proposed PBR through Dr. Lawrence Kaufmann and Joseph Bodanza, Senior Vice President – Regulatory for KeySpan Energy Delivery New England. See Exh. KEDNE/LRK-1 and Exh. KEDNE/JFB-1, respectively.

The Department issued its Order of Notice on April 24, 2003. Pursuant to that order, and under an appropriate Motion, Bay State Gas Company (“Bay State”) was granted full party status. Tr. 5/23/03. Discovery on Boston Gas’s filing ensued, and on July 7, 2003, the Attorney General of the Commonwealth (“Attorney General”), through its witness Lee Smith of LaCapra Associates, filed testimony relative to the proposed PBR. Exh. AG-41.

## **II. SUMMARY OF POSITION**

Bay State supports the PBR articulated by Boston Gas, where some adjustments for inflation and productivity are contemplated, as this proposal is consistent with the Department’s standards for incentive ratemaking. Bay State, however, asks the Department to acknowledge that, if PBRs work as they should, companies operating

under a second-term of any rate plan that includes a rate freeze component will not be capable of significant incremental efficiencies that are intended to be reflected in the consumer dividend. Accordingly, this number should be a low number, if included at all, absent some demonstrable technological improvement that would increase the opportunity to drive further efficiencies in natural gas operations and services. Finally, no matter what outcome is determined for Boston Gas's PBR proposal, the Department should investigate each utility's proposed rate construct on a case-by-case basis, whether it incorporates elements of a prior approved plan or initiates new rate proposals for approval.

### **III. SUMMARY OF BOSTON GAS PBR**

Boston Gas designed the PBR to be initiated as a result of this proceeding to be "substantially similar" to that approved by the Department in D.P.U. 96-50. Boston Gas recognizes that cast-off rates should be equitable, but that the Company should receive increases based on inflation throughout the term of the plan. This acts as a price cap on the amount Boston Gas can charge its customers.

Boston Gas proposes that the plan be in effect until October 31, 2008. Exh. KEDNE/JFB-1 at 27. Boston Gas also proposes that the Department approve an "evergreen" provision, such that the plan would continue year-to-year, subject to the Department's approval of a compliance filing made each September 15 by Boston Gas. Exh. KEDNE/JFB-1 at 27-28; Exh. DTE-6-10.

In addition, Boston Gas proposes to maintain the earning sharing mechanism proposed and approved in D.P.U. 96-50, which provides that a bandwidth of 400 basis points would be established around the authorized return of equity of 12.18 percent. Exh.

KEDNE/JFB-1 at 26. If the actual ROE is below 6.16 percent, shareholders and ratepayers share the burden of any loss 75/25; if the actual ROE is above 16.18 percent, the sharing of the gain is also 75/25 respectively. Id.

Most of the plan is consistent with the conditions approved by the Department in D.P.U. 96-50, with some notable exceptions. For instance, the Company did not include accumulated inefficiencies in the calculation of the X factor, justifying the omission by stating that accumulated inefficiencies are only applicable to the first term of a price-cap plan under the Department's precedent, if at all. Exh. KEDNE/LRK-1 at 17; Exh. DTE-6-20; see also Berkshire Gas Co., D.T.E. 01-56 (2002) (no accumulated inefficiencies included in approved X factor for first term PBR); see also, Boston Gas Co. v. Department of Tel. & Energy, 436 Mass. 233; 763 N.E.2d 1045 (2002).

With regard to the consumer dividend, Boston Gas proposes reducing it to a level consistent with a utility that has already been under price cap cost containment for seven years. See Exh. KEDNE/JFB-1 at 24; Exh. KEDNE/LRK-1 at 15-16.

With regard to its productivity study, Boston Gas promotes use of the differential between the total factor productivity ("TFP") trends for the gas industry and the US economy. Exh. KEDNE/LRK-1 at 3-5.

#### **IV. ARGUMENT**

##### **A. KeySpan's PBR is Consistent with the Department's Standards for Incentive Ratemaking**

Under the Department's requirements, an incentive proposal must demonstrate that its approach is more likely than cost of service regulation to advance the Department's goals of safe and reliable energy and to promote the objectives of economic

efficiency, cost control, lower rates, and reduced administrative burden in regulation.

Incentive Regulation, D.P.U. 94-158 at 57, 66.

In fact, the PBR plan approved by the Department in D.P.U. 96-50 has been proven to have contained Boston Gas's costs, to have driven efficiencies, and to have reduced the need for administratively wasteful and time-consuming rate proceedings. Exh. KEDNE/JFB-1 at 4, 21; Exh. DTE-6-1; Exh. DTE-6-4; Exh. DTE-6-15. In the ten years prior to Boston Gas's PBR, the Company was able to demonstrate a legitimate basis for a base rate increase every 2.5 years, together totaling approximately \$70 million. Exh. DTE-6-4, citing Boston Gas Co., D.P.U. 96-50 (1996); Boston Gas Co., D.P.U. 93-60 (1993); Boston Gas Co., D.P.U. 90-17/18/55 (1990); Boston Gas Co., D.P.U. 88-67 (1988). Expenses in nominal dollars rose by 4.9% per year before the PBR. However, during the PBR, expenses rose by just 2.3% per year (in nominal dollars) between 1996 and 2002. Exh. DTE 6-1(a). In real dollars, these amounts were 2.1% and 0.6% respectively. Exh. DTE-6-1. Total cost savings attributable to Boston Gas's PBR are estimated at \$4.065 million. Exh. DTE-6-51; see also, Exh. DOER-2-12.

The Department also requires incentive plans to be consistent with controlling statutes and regulations, and provide a "minimum time horizon to give the incentive plan enough time to achieve its goals," while not creating undue risk for the utility or consumers. Incentive Regulation, D.P.U. 94-158 at 58, 66. In this regard, the five-year term proposed by Boston Gas supports the employment of carefully designed incentive rates to continue inducing efficiencies during the term of the plan, "striking a balance between creating incentives and reflecting recent experience on the industry's input price and TFP growth." Exh. DTE-6-11. A 10-year term for the PBR, if one were ordered by

the Department, would be inappropriate and would not serve to benefit ratepayers, even if returns were adjusted to reflect additional risk. See RR-DTE-44; RR-DTE-43; Exh. DTE-6-11 (consumers may not benefit from increases in industry TFP during the longer term). Quite simply, absent an agreement by the utility to a 10-year PBR term, under Massachusetts law, a utility may file for a rate increase at any time if rates are not just and reasonable. See, G.L. c. 164, sec. 94; see also, Exh. DTE-6-11 (price cap may not be set at level that allows return of capital additions made during the period); Exh. DTE-6-4 (increased risks must be reflected in higher return on equity). The Department may not, by order, alter substantive rights established by statute and elsewhere. Likewise, at anytime, the Attorney General may seek a rate investigation by the Department if Boston Gas's rates were demonstrated to be unjust and unreasonable. See, G.L. c. 164, sec. 93. For these reasons, Boston Gas's proposed five-year term is reasonable.

The Department seeks to ensure that there is a reduction in administrative and regulatory cost in each incentive plan. Incentive Regulation, D.P.U. 94-158 at 64-65, 66. As Boston Gas indicated, its proposed PBR seeks for the Company to retain flexibility to allocate the price cap increase between rate elements within a class, as long as no rate component increases by more than the rate of inflation. Exh. KEDNE/JFB-1 at 27; Exh. MDFA-1-9. This flexibility, which is consistent with Boston Gas's prior plan, reduces the need for rate reviews and detailed rate design proposals. Boston Gas Co., D.P.U. 96-50 at 333-334; Incentive Regulation, D.P.U. 94-158 at 64-65.

The Department also permits incentive plans to reward utility performance and to address the issue of the recovery of exogenous cost. Incentive Regulation, D.P.U. 94-158 at 61, 66. As stated, the PBR under consideration maintains the existing level of sharing

and risk allocation between customers and the utility for both increases and decreases in revenue. Exh. KEDNE/JFB-1 at 26. For Boston Gas, the proposed threshold level of recovery under the exogenous cost factor remains the same as that calculated for the purposes of its prior PBR. Exh. DTE-6-9; Exh. KEDNE/JFB-1 at 26; see also Boston Gas Co., D.P.U. 96-50 (Phase I). Bay State agrees with Boston Gas that this element of the PBR Plan, which accounts for the impact of costs beyond the utility's control, is appropriately identified at the commencement of the plan so all parties understand at the outset what level of exogenous cost will trigger a filing under the mechanism. Exh. DTE-6-9.

Bay State Gas believes that Boston Gas's PBR is consistent with law, is consistent with the theories of market-based regulation and enhanced competition, is consistent with the utility's obligation to safeguard system reliability, integrity, and policy objectives, will reward performance while addressing costs outside the Company's control, will focus on results, incorporates defined measures for performance, is an appropriate length, and reduces regulatory and administrative cost. Accordingly, it should be approved by the Department as reasonable. See, Incentive Regulation, D.P.U. 94-158 at 66.

B. Efficiencies are Maximized Early-on; Future Opportunity to Find Efficiencies Will be Reduced Over Time

The consumer dividend reflects future gains in productivity resulting from the change in regulatory paradigm from cost-based ratemaking to incentive ratesetting. Exh. AG-11-54; Boston Gas Co., D.P.U. 96-50 at 280. To the extent this is true, absent a demonstrable, pro forma-type adjustment for technological innovation, the most appropriate value for a consumer dividend will be zero as PBR regulation moves forward

into the future. Exh KEDNE/LRK-1 at 6; see Exh. AG-30-2. Even where a long-term price cap has reduced the opportunities to drive efficiencies and the consumer dividend is set at zero, a price cap or PBR will still provide ratepayer benefits. See Exh. AG-30-2; Exh. DTE-6-8.

As Dr. Kaufmann stated, “it will become more difficult to achieve incremental productivity gains in the Company’s next PBR plan.” Exh. KEDNE/LRK-1 at 14. Incremental productivity gains exceed what can be expected by the productivity factor. Exh. DOER-2-2. Bay State agrees with Boston Gas on this point. As each year passes during which a company has had to operate under a price cap, efficiencies (actual, not theoretical) have been maximized and the consumer dividend must be reduced to reflect this fact. Exh. KEDNE/JFB-1 at 24. Boston Gas’s use of historical evidence (rather than forward-looking projections), in Bay State’s view, results in a generous assessment of efficiencies that can be driven in the next five years. See Exh. DOER-2-2 (Company used historical evidence when proposing values for both the productivity factor and the consumer dividend). Accordingly, the Company’s proposed consumer dividend of .15 percent is reasonable. Exh. KEDNE/JFB-1 at 24; Exh. AG-11-54.

Gas distribution TFP growth is below the growth in input prices, so therefore unit costs are on the rise for the gas distribution industry. Exh. AG-30-2; Exh. DTE-8-5. There is less rapid growth in the industry than in the U.S. economy as a whole. Exh. DTE-8-5. These two facts alone would drive more frequent rate proceedings under traditional cost of service regulation, which ratesetting costs would then be borne by consumers. Id. See Exh. AG-30-2 (management should focus on core business and seek

to maximize smaller efficiencies with available resources, rather than devote those resources to regulatory processes).

The two incentives at the core of every PBR Plan (that is, to pursue (even marginal) productivity gains and to avoid base rate proceedings over a prolonged period) will continue to provide benefits for ratepayers and utilities over cost of service regulation. See, Exh. DTE-6-6.

As Dr. Kaufmann indicated, the Company has a strong incentive to control costs because its prices are set based on external cost data. Exh. DOER-2-1. Therefore, under the inflation-plus PBR formula, productivity increases will continue to be sought. In addition, it is notable that with the lag between implementing an efficiency measure and the payout in reduced cost, the sooner an efficiency measure is implemented, the sooner the Company will see the impact and the longer it will benefit from it. See, Exh. DOER-2-1. With fewer regulatory filings associated with rate cases under cost of service regulation, the Company is able to not only avoid the direct costs associated with ratecase litigation, but focus on its core mission of providing its customers with safe and reliable natural gas distribution service. See, id.

Accordingly, the Department should find that while efficiency gains may be had during the Company's second term of PBR, any gains will be reduced in magnitude. While PBR still provides the correct incentives for cost control and is preferable to traditional cost of service regulation, the calculation of the consumer dividend should be adjusted accordingly.

C. All Rate Proposals Should be Reviewed on a Case-By-Case Basis

In the Department's order in Incentive Regulation, the Department analyzed in detail the benefits of a PBR rate construct versus a cost of service paradigm. Incentive Regulation, D.P.U. 94-158 (1995). The Department's goal in this generic proceeding was clearly to create a regulatory environment that would induce maximum progress toward the least-cost provision of safe and reliable utility service. Incentive Regulation, D.P.U. 94-158 at 66-67.

The Department noted that cost of service regulation may create an incentive to spend at greater levels while not seeking efficiencies, to cross-subsidize, to unduly seek to eliminate risk and to disincent innovation, among others. Incentive Regulation, D.P.U. 94-158 at 9. The Department found that the benefits possible under incentive regulation were not possible at the same level under cost of service regulation. Incentive Regulation, D.P.U. 94-158 at 52-53.

It is important to recognize that the Department's generic incentive regulation proceeding promoted objectives. Incentive Regulation, D.P.U. 94-158 at 66. Within reason, the Department should remain open to alternative arguments as to how those objectives may be achieved. If alternative methods can be demonstrated to advance the Department's traditional goals of safe, reliable and least-cost service and to promote the objectives of economic efficiency, cost control, lower rates and reduced administrative burden in regulation, such methods should be fully evaluated. See RR-DTE-41; see also Incentive Regulation, D.P.U. 94-158 at 54-55.

While Boston Gas did not consider any other alternative performance-based rate plans, the precedent it considers applicable to it may not be the only alternative suitable to other companies. See Exh. MDFA-3-3. Other alternatives may be consistent with Incentive Regulation, and provide additional benefits to consumers and the utility, and still differ from Boston Gas's plan. See e.g. Exh. DTE-6-15 (Boston Gas itself will continually reevaluate the PBR proposals given operating conditions). The Department should reaffirm its prior policy and state that it will not insist on a one-size-fits-all approach for each of its regulated utilities. See PERFORMANCE BASED REGULATION FOR DISTRIBUTION COMPANIES (Report Prepared for NARUC), *The Regulatory Assistance Project* at 18-19, 42 (Dec. 2000) (set goals for a PBR, but remain flexible as to how they are achieved).

## **V. CONCLUSION**

Wherefore, for all the reasons set forth in this Initial Brief, Bay State Gas Company respectfully requests that the Department of Telecommunications and Energy issue its Final Order making its findings consistent with the positions stated herein.

Respectfully submitted,

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